

**STATE OF WASHINGTON
OFFICE OF THE INSURANCE
COMMISSIONER**



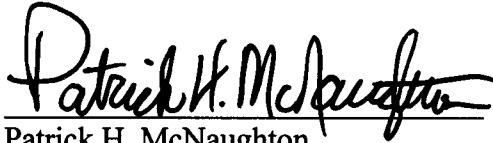
**FINANCIAL EXAMINATION
OF
PEMCO LIFE INSURANCE COMPANY
SEATTLE, WASHINGTON**

**NAIC CODE #71803
DECEMBER 31, 2003**

Participating States:
Washington

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of the PEMCO LIFE INSURANCE COMPANY of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 2003.

A handwritten signature in black ink, reading "Patrick H. McNaughton". The signature is written in a cursive style with a large initial "P" and a long horizontal stroke at the end.

Patrick H. McNaughton
Chief Examiner

5-18-05

Date

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SALUTATION

Seattle, Washington
May 17, 2005

The Honorable Alfred W. Gross, Commissioner
Chair, NAIC Financial Condition (E) Committee
State Corporation Commission
Bureau of Insurance
Commonwealth of Virginia
PO Box 1157
Richmond, VA 23218

The Honorable Linda Hall, Director
Alaska Division of Insurance
Secretary, Western Zone
550 West 7th Avenue, Suite 1560
Anchorage, AK 99501-3567

The Honorable Mike Kreidler, Commissioner
Washington State Office of the Insurance Commissioner (OIC)
Insurance 5000 Building
5000 Capital Blvd.
Tumwater, WA 98504-0255

Dear Commissioners and Director:

In accordance with your instructions and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

PEMCO LIFE INSURANCE COMPANY
of
Seattle, Washington

hereinafter referred to as "PLIC" or the "Company", at its home office located at 325 Eastlake Avenue East, Seattle, Washington 98109-5466. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 2003.

SCOPE OF EXAMINATION

This examination covered the period January 1, 1999 through December 31, 2003 and comprises a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administration Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of any material transactions and events occurring subsequent to the date of examination that were noted during the examination. The findings of the previous examination report were reviewed and all items were satisfactorily addressed by the Company.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

INSTRUCTIONS

The examiners reviewed the Company's filed 2003 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW and Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the NAIC's Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review.

1. Conflict of Interest

PLIC's Conflict of Interest Policy requires that conflict of interest disclosures be updated every three years. For the examination period, there was only one disclosure form each for one officer and one director, although the other officers and directors complied with the policy.

RCW 48.05.370 states, "Officers and directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions." In order to monitor compliance with this statute, the Company is instructed to obtain and review conflict of interest declarations from appropriate

personnel and to report the results to the Company's Board of Directors, as required by the Conflict of Interest Policy.

2. Internal Audit Department

During the period covered by our examination, the internal audit department performed no audits. This coverage should be evaluated by comparing it to an objective prioritization of significant, sensitive control areas and cycles. If it is found to inadequately cover the required areas in either scope or frequency, consideration must be given to strengthening the department or refocusing its mission. Currently, the department consists of three professionals and the organization charts shows that its resources are diverted to other tasks such as contract administration. This situation is of particular concern, since the Company has no Audit Committee to monitor the department's scope, coverage or results.

The Company is instructed to comply with RCW 48.05.370, which states that officers and directors "...shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions". This should include creating an Audit Committee which would be responsible for ensuring that the Internal Audit Department adequately covers significant, sensitive control areas and avoids even the appearance of subjectivity by devoting all its resources to performing internal audits.

3. Custodial Agreement

In the 2003 NAIC Annual Statement Interrogatory #22.01, the Company stated that its Custodial Agreement with US Bancorp complied with the NAIC Financial Condition Examiner's Handbook. However, the Company's agreement contained the following deficiencies:

- The Agreement does not allow PLIC's securities that are not held subject to deposit requirements to be withdrawable upon demand.
- For the loss of securities which US Bank is obligated to indemnify PLIC, the Agreement does not clearly require US Bank to promptly replace the securities or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities.
- The Agreement does not require US Bank to allow an officer or employee of PLIC, an independent accountant selected by PLIC, and a representative from the OIC, to be entitled to examine US Bank's records relating to the securities on the premises of US Bank during regular business hours.
- To the extent that certain information maintained by US Bank is relied upon by PLIC in preparation of its NAIC Annual Statement and supporting schedules, the Agreement does not require US Bank to maintain records sufficient to determine and verify such information.

- The Agreement does not require insurance by the custodian.

The Company is required to follow the NAIC's Annual Statement requirements as noted in WAC 284-07-050(2). Adherence to the FCEH is one of these requirements. The Company is instructed to correct all deficiencies noted above and execute a revised or amended custodial agreement.

COMMENTS AND RECOMMENDATIONS

1. Separation of Duties

Except for the accounts receivable and cash deposit functions; almost the entire financial accounting process is performed by one employee.

The Company's small size narrows the pool of available personnel needed for a separation of functions. However, PLIC's financial processes should be reviewed and strengthened to improve cross-checking and functional separation. For example, it may be possible to utilize personnel across Company lines to achieve that end.

2. Perception of Governance

Although the PEMCO companies are not publicly held, it is advisable to configure any company's governance and internal control procedures to comply with public company requirements. Currently, the Company's president is included on most important committees and possesses approval authority for most transactions and payment facilities, although there may be cultural and even actual controls to mitigate or offset these powers. This authority may be understood within the Company as being traditional and possibly minimal, but to an external party, it could give a negative impression, especially in the absence of an audit committee.

It is recommended that the entire subject of corporate governance, internal controls and approval powers be reviewed and adjusted if appropriate.

3. Control of Reinsurance Contracts

PLIC receives reports from its reinsurers analyzing reinsurance pricing and performance with respect to both PLIC's and the reinsurers' results. Negotiation of PLIC's reinsurance contract terms comes directly out of the reinsurers' analyses. The Product Department and Company actuaries coordinate this process, but no one at PLIC is responsible for performing an analysis or developing a rationale for approving its reinsurance contracts.

It is recommended that PLIC analyze, develop a rationale for, and document its process for approval of its reinsurance contracts.

COMPANY PROFILE

Company History

The OIC's previous examination covered the period January 1, 1993 to December 31, 1998.

PLIC is a Washington corporation organized as a stock life insurance company on May 27, 1963. The Company's Certificate of Authority was issued on June 11, 1963 and authorized the business of life and disability insurance. The Company is a wholly owned subsidiary of PEMCO Corporation.

Territory and Plan of Operation

The Company is licensed to operate in the state of Washington.

PLIC employs a direct distribution system using Life Sales Specialists. In addition, the Company uses independent community agents who also represent PEMCO Mutual Insurance Company (PMIC).

Growth of Company

The Company's growth, as reported in its filed NAIC Annual Statements, is shown below.

	<u>Assets</u>	<u>Liabilities</u>	<u>Capital and Surplus</u>
1999	\$6,964,804	\$1,674,979	\$5,299,614
2000	6,974,593	2,016,840	4,947,967
2001	7,048,671	1,866,113	5,182,557
2002	7,116,631	2,042,126	4,949,504
2003	7,429,964	2,464,148	4,840,816

	<u>Premiums</u>	<u>Net Investment Income</u>	<u>Death Benefits</u>
1999	\$924,270	\$350,638	\$436,038
2000	1,085,775	335,423	261,397
2001	1,051,927	349,130	231,008
2002	1,229,664	291,527	409,647
2003	1,392,815	267,011	314,474

Affiliated Companies

PEMCO Corporation (CORP) is a stock company that was incorporated in the state of Washington during April 1962. It owns 100% of PLIC and is owned 39.76% by PMIC.

PEMCO Mutual Insurance Company (PMIC) is organized as a mutual insurer in the state of Washington. The Company writes multiple-lines property and casualty coverage for the general public.

PEMCO Insurance Company (PIC) was incorporated on May 4, 1972, as a stock multiple line property and casualty insurance company under the laws of the state of Washington. The Company is authorized to write property, vehicle, casualty and surety insurance.

PEMCO Corporation (CORP) is a stock company that was incorporated in the state of Washington during 1983. CORP provides data processing services, and leases automobiles and office equipment to the three insurance companies and other companies under common management.

Washington State Teachers Credit Union (WSTCU) was founded by Robert J. Handy and a group of educators in 1936. Today, the Credit Union is one of the largest members owned credit unions in the state.

Teachers Credit Company (TCC) was incorporated under the laws of the state of Washington during 1941.

Evergreen Bank (EB), formerly Teachers State Bank, was incorporated under the laws of the state of Washington on December 28, 1970 and commenced business on October 1, 1971. EB provides banking services for all affiliated companies.

Public Employees Insurance Agency (The Agency) is a stock company incorporated in the state of Washington during October 1968. The Agency sells insurance and collects premium on behalf of the affiliated insurance companies.

Intercompany Contracts

As of December 31, 2003, the Company was a party to the following intercompany contracts:

Tax Sharing Agreement	January 1, 2001
Shared Services Agreements	January 1, 2000
Cost Sharing Agreements	January 1, 2003
Loss of Surplus Insurance (See Reinsurance on page 8)	January 1, 1991

MANAGEMENT AND CONTROL

Board of Directors (BOD)

As of December 31, 2003, the Company was controlled by a nine-member BOD of which seven are outside directors. All BOD members are elected for a one-year term at the annual stockholders' meeting.

<u>Name</u>	<u>Principal Business Affiliation</u>
Stan W. McNaughton	President and Chief Operating Officer
Diane K. Beckley	Retired
Gayle C. Glass	Vice President, Human Resources – Pemco Mutual Insurance Company
Hugh R. McGough	General Counsel – Pemco Mutual Insurance Company
Steve A. Ricco	Treasurer

Officers

On December 31, 2003, the officers were:

Stan William McNaughton	President
Steven Anthony Ricco	Treasurer
Denice Marie Town	Secretary

Committees

The BOD has the authority to appoint such additional standing or temporary committees as the Board may deem necessary. The only active committee during the period of the examination was the Investment Committee which submitted its minutes to the BOD.

Conflict of Interest

All affiliated companies have a combined Conflict of Interest and Confidentiality Policy which requires completion of a conflict of interest statement by officers, directors and key employees every three years. All are required to disclose relevant outside interests, memberships, associations and affiliations to the president, chairman, or BOD of the respective company. The Company provided only one conflict of interest disclosure for an officer and director. The other officers and directors complied with the policy.

Fidelity Bond and Other Insurance

The Company has a Fidelity Institution Bond with Hartford Fire Insurance Company with a Single Loss Limit of Liability of \$5,000,000 and a Single Loss Deductible of \$25,000. This bond covers all Company employees.

Officers', Employees', and Agents' Welfare and Pension Plans

The Company offers a 401(k) Savings and Profit Sharing Plan. This is a defined contribution plan where the employer pays eligible employees for their contributions to the continued success

of the Company. Employees may contribute up to 15% of their salary to the plan, which is subject to a two-for-one Company match of the first 6%.

The Company offers a non-qualified deferred compensation plan for certain senior executives and directors of the Company.

In addition to deferred compensation benefits, the Company provides certain medical and dental insurance coverage for retired employees. Employees become eligible for these benefits by attaining age 62 with at least 15 years of service.

CORPORATE RECORDS

The initial Articles of Incorporation were adopted by the Company organizers on May 23, 1963 and were filed with the state of Washington in accordance with the Washington Insurance Code. There have been no amendments to these Articles.

The corporate bylaws were amended once during the examination period. On November 15, 2001, the Chairman's duties were revised.

The BOD was active during the examination period. Meetings were well attended and the minutes demonstrated that the BOD members were actively involved in the administration of the Company's affairs. All meetings were documented in writing, noting discussion items and specific actions taken.

LOSS EXPERIENCE

The OIC Actuary reviewed the reserves and related assets and liabilities associated with policy coverages in group, credit, and individual term and whole life insurance contracts underwritten by the Company.

A review of the Company's underlying data integrity concluded that there were no indications of any significant inaccuracies or inconsistencies in the available underlying data.

The Company provided copies of its actuarial workpapers and reserve reports as of December 31, 2003. Tests were performed on the underlying data, methods, and calculations as deemed necessary. Valuation reports and procedures were tested to establish that accurate and complete in-force information, as of December 31, 2003, was represented in the valuation reports and workpapers. A sampling of contracts and payments was taken from active life and disabled life reserve reports, premium collection records and paid claims reports. The samples were tested for completeness and accuracy and it was determined that the Company's calculations were based on accurate and complete demographic data.

During the course of the examination, the OIC actuary performed such testing of the Company's reserving methodologies and philosophies as was deemed necessary to form an opinion with respect to the items reported.

Based on the examiners' assessment of control risk on Losses and Benefits Cycle: Life, controls were tested to determine whether the reserving procedure was operating as expected, applied

throughout the entire period of reliance, performed on a timely basis, and encompassed all transactions and identifying errors. Testing procedures were made by inquiry, observation, re-performance, and examination of documents provided by Company through its Appointed Actuary. The OIC Actuary relied upon the Company's listings and summaries of in-force policies and contracts.

The general examination emphasis was to review the methods, assumptions or other bases used to determine the reported NAIC Annual Statement items, and to determine whether the reported amounts are sufficient and in compliance with Washington law.

In the OIC Actuary's opinion, the reserving methods, assumptions and methodologies used by the Company are generally appropriate, and all material relevant assets and liabilities on the NAIC Annual Statement were reported in accordance with the Actuarial Guidelines issued by the Actuarial Standards Board of the American Academy of Actuaries as they appear in Appendix C of the NAIC Accounting Practices and Procedures Manual.

REINSURANCE

The Company assumes no reinsurance. It has a number of ceded reinsurance contracts with authorized reinsurers, covering various products on either a yearly renewable term or a coinsurance basis.

The Company also has an "Insurance Agreement" with PMIC, whereby PLIC is to be reimbursed up to a maximum of \$500,000 "...for the amount of any surplus loss exceeding \$500,000 as of December 31".

All the contracts have insolvency clauses and other wording generally utilized in such agreements.

ACCOUNTING RECORDS AND INFORMATION SYSTEMS

The Company maintains its accounting records on a modified GAAP accrual basis of accounting and adjusts to Statutory Accounting Practices (SAP) basis for NAIC Annual Statement reporting. The Company is audited annually by the certified public accounting firm of PriceWaterhouseCoopers. The Company received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no exceptions were noted.

The management of the Company is sufficiently knowledgeable of the information systems (IS) process. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that appropriate controls are in place. Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. Sufficient internal controls are in place and monitored by the Company. The Company's IS Department has the ability to recover from an incident or disaster and has documented these procedures in a detailed, written disaster recovery plan.

SUBSEQUENT EVENTS

NONE

FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS

All previous report instructions and comments have been corrected.

FINANCIAL STATEMENTS

Assets, Liabilities, Surplus and Other Funds

Summary of Operations

Reconciliation of Surplus For the Period Since the Last Examination

PEMCO LIFE INSURANCE COMPANY
ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS

December 31, 2003

	<u>BALANCE PER COMPANY</u>	<u>EXAM ADJ</u>	<u>BALANCE PER EXAM</u>
<u>Assets</u>			
Bonds	\$4,671,908	\$0	\$4,671,908
Preferred Stocks	100,000		100,000
Cash and short term investments	1,525,770		1,525,770
Contract loans	737		737
Subtotals, cash and invested assets	<u>6,298,415</u>	<u>\$0</u>	<u>6,298,415</u>
Investment income due and accrued	78,340		78,340
Premiums and considerations:			0
Uncollected premiums and agents' balance			0
in course of collection	32,828		32,828
Deferred premiums, agents' balances and			0
installments booked but deferred and not yet due	787,873		787,873
Reinsurance:			0
Other amounts receivable under reinsurance			0
contracts	24,443		24,443
Guaranty funds receivable or on deposit	6,673		6,673
Electronic data processing equipment and software			0
Receivable from parent, subsidiary and affiliates	201,392		201,392
Other assets nonadmitted			
Total Assets	<u>\$7,429,964</u>	<u>0</u>	<u>\$7,429,964</u>
<u>Liabilities</u>			
Aggregate reserve for life contracts	1,859,296	\$0	1,859,296
Contract claims:			0
Life	95,624		95,624
Premiums and annuity considerations for life and			0
accident and health contracts received in advance	50,930		50,930
Interest Maintenance Reserve	18,118		18,118
Commissions to agents due or accrued	20,097		20,097
General expenses due or accrued	271,122		271,122
Taxes, licenses and fees due or accrued	13,200		13,200
Current federal and foreign income taxes	1,311		1,311
Net deferred tax liability	106,937		106,937
Miscellaneous Liabilities:			0
Asset valuation reserve	14,347		14,347
Payable to parent, subsidiary and affiliates	13,001		13,001
Aggregate write-ins for liabilities	165		165
Total Liabilities	<u>\$2,464,148</u>	<u>\$0</u>	<u>\$2,464,148</u>

PEMCO
LIFE INSURANCE COMPANY
ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS (Continued)
December 31, 2003

	<u>BALANCE PER</u> <u>COMPANY</u>	<u>EXAM</u> <u>ADJ</u>	<u>BALANCE PER</u> <u>EXAM</u>
Common Stock	125,000	\$0	125,000
Gross paid in and contributed surplus	75,000		75,000
Unassigned surplus	<u>4,765,816</u>	<u> </u>	<u>4,765,816</u>
Surplus	<u>4,965,816</u>	<u> </u>	<u>4,965,816</u>
Total liabilities, surplus and other funds	<u><u>\$7,429,964</u></u>	<u><u>\$0</u></u>	<u><u>\$7,429,964</u></u>

PEMCO LIFE INSURANCE COMPANY
SUMMARY OF OPERATIONS
YEAR ENDED
DECEMBER 31, 2003

	<u>BALANCE</u> <u>PER COMPANY</u>	<u>REF</u>	<u>EXAM</u> <u>ADJ</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>
<u>INCOME</u>				
Premiums and annuity considerations	\$1,392,815		\$0	\$1,392,815
Net investment income	267,011			267,011
Commission and Expense Allowance	311,936			311,936
Amortization of Interest Maintenance Reserve	773			773
TOTAL INCOME	<u>\$1,972,535</u>		<u>\$0</u>	<u>\$1,972,535</u>
<u>BENEFITS</u>				
Death Benefits	\$314,474			\$314,474
Surrender Benefits	6,195			6,195
Increase in aggregate reserves for life and health policies and contracts	331,160			331,160
TOTAL BENEFITS	<u>\$651,829</u>		<u>\$0</u>	<u>\$651,829</u>
<u>EXPENSES</u>				
Commissions on premiums and annuity considerations	195,807			195,807
General insurance expenses	1,282,701			1,282,701
Insurance taxes, licenses and fees, excl. federal income tax	96,112			96,112
Increase in loading	(34,118)			(34,118)
Aggregate write-ins for expenses	6,701			6,701
TOTAL EXPENSES AND BENEFITS	<u>\$2,199,032</u>		<u>\$0</u>	<u>\$2,199,032</u>
Net gain from operations before dividends to policyholders and income taxes	(226,497)			(226,497)
Dividends	0		0	0
Less Federal income taxes incurred (excl. tax on capital gains)	(221,997)		0	(221,997)
Net gain from operations after dividends to policyholders and income taxes but before realized capital gains (losses)	(4,500)			(4,500)
Net realized capital gains or (losses) less capital gains tax	0			0
NET INCOME	<u>(\$4,500)</u>		<u>\$0</u>	<u>(\$4,500)</u>

PEMCO LIFE INSURANCE COMPANY
RECONCILIATION OF SURPLUS
FOR THE PERIOD SINCE THE LAST EXAMINATION

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Capital and Surplus, December 31, Previous Year	\$5,074,504	\$5,182,556	\$4,947,965	\$5,299,614	\$5,342,762
Net income	(4,500)	(15,702)	30,970	(215,653)	(56,103)
Change in net unrealized capital gains (losses)					
Change in net deferred income tax	(129,843)	(151,915)	89,609		
Change in reserve on acct of change in valuation basis		2,444			
Change in non-admitted assets and related item	24,504	58,340	32,721	(133,612)	
Change in asset valuation reserve	2,048	(1,219)	(749)	(1,015)	(1,060)
Capital Changes – Paid In					
Cumulative effect of changes in accounting principles		0	78,575		
Aggregate write-ins for gains and losses in surplus	(897)		3,465	(1,369)	14,015
Net change in capital and surplus for the year	(108,688)	(108,052)	234,591	(351,649)	(43,148)
Capital and surplus current year	<u>\$4,965,816</u>	<u>\$5,074,504</u>	<u>\$5,182,556</u>	<u>\$4,947,965</u>	<u>\$5,299,614</u>

NOTES TO FINANCIAL STATEMENTS

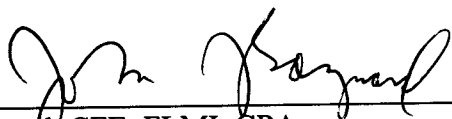
The Company has no special consents, permitted practices or orders from the state of Washington.

ACKNOWLEDGEMENT

The cooperation and assistance of the officers and employees of the Company during the examination are hereby acknowledged.

In addition to the undersigned, Susan J. Campbell, CPA, FLMI, Kehinde Ovbiebo, Keith Henderson, CFE, CPA and Constantine Arustamian, CFE, CPA; Alexis S. Santos, FSA, MAAA; Michael V. Jordan, CPA, CFE, MHP and John Jacobson, AFE, all from the OIC, participated in the examination and the preparation of this report.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "John Gaynard", is written over a horizontal line.

John Gaynard, CFE, FLMI, CPA

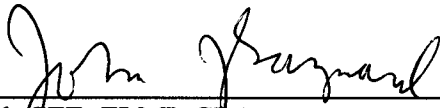
Examiner-in-Charge

Washington State Office of the Insurance Commissioner

AFFIDAVIT

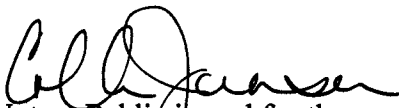
State of Washington)
) ss
County of King)

John Gaynard, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.



John Gaynard, CFE, FLMI, CPA
Examiner-in-Charge
State of Washington

Subscribed and sworn to before me on this 18th day of May, 2005.



Notary Public in and for the
State of Washington

